



THE CHAIRMAN

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

June 6, 2005

The Honorable Paul E. Kanjorski  
Ranking Member  
Subcommittee on Capital Markets, Insurance  
and Government Sponsored Enterprises  
U.S. House of Representatives  
2188 Rayburn House Office Building  
Washington, DC 20515

Dear Congressman Kanjorski:

I write in response to your April 12, 2005 letter, in which you request technical assistance in providing greater detail about the statutory authority the Commission may need if Congress determines that it is appropriate to create a comprehensive oversight regime for credit rating agencies.

In response to your request, I am enclosing an outline prepared by Commission staff that sets forth key authority issues that potentially would need to be addressed if Congress were to enact a legislative framework for the oversight and regulation of credit rating agencies. As you know, the Commission has not taken a formal position on the need for legislation.

Please let me know if we may be of further assistance.

Sincerely,

A handwritten signature in black ink, reading "Bill Donaldson".

William H. Donaldson

Enclosure

## **STAFF OUTLINE OF KEY ISSUES FOR A LEGISLATIVE FRAMEWORK FOR THE OVERSIGHT AND REGULATION OF CREDIT RATING AGENCIES**

I. Overview of Legislation. Credit rating agencies play an important role in the securities markets, but Congress has not expressly provided for any formal regulation of their activities. Longstanding concerns regarding the lack of a regulatory framework for credit rating agencies were heightened during the financial collapse of several large public companies. The purpose of any proposed legislation would be to provide the legal authority necessary to establish an effective oversight and examination regime to assure that credit rating agencies operate in a transparent manner, with adequate policies and procedures designed to ensure the credibility and reliability of the rating process, and full disclosure of, or restrictions on, conflicts of interest and anti-competitive practices.

To achieve these objectives, legislation could require nationally recognized statistical rating organizations (“NRSROs”) and certain other credit rating agencies to register and become regulated by the Securities and Exchange Commission. The Commission, which has for several decades evaluated credit rating agencies through a staff no-action process, could be authorized to adopt substantive rules governing rating agency activities and would have examination, inspection, and enforcement authority. The Commission would *not* be expected to regulate the substantive decision-making of rating agencies or the content of the ratings they assign, issues that can best be addressed through the operation of a free and competitive marketplace.

II. Registration Requirements. Registration with the Commission typically is a key element in the Commission’s oversight and regulation of securities market participants. Accordingly, a legislative approach could require certain credit rating agencies to register with the Commission. The Commission historically has been concerned primarily with those credit rating agencies that have the greatest market impact – those who by widespread dissemination of their ratings have become “nationally recognized.” Accordingly, the legislation could require any credit rating agency that is designated as an NRSRO by the Commission (on its own motion or by application) to register with the Commission. For this purpose, an NRSRO could be defined, as recently proposed by the Commission, as a credit rating agency (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments and (ii) that is generally accepted in the financial markets as an issuer of credible and reliable securities ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings in the United States. In addition, the Commission could be given rulemaking authority to require a credit rating agency that does not meet the definition of NRSRO to register with the Commission and become subject to regulation, if the activities of the credit rating agency have a significant impact on the securities markets or pose a risk to investors, or otherwise as may be necessary or appropriate in the public interest.

III. Rulemaking Authority. Consistent with the Commission’s statutory authority over other regulated entities, any legislation proposed could provide the Commission with broad authority to adopt rules in each of the key areas of concern. This approach may be preferable to trying to embed rigid prohibitions and requirements in statutory

language that could not be easily amended. Thus, the legislation could provide the Commission with authority to adopt rules in the following areas with respect to registered credit rating agencies:

- *Conflict of Interests.* The Commission could be given authority to adopt rules prohibiting or requiring the disclosure of conflicts of interest, such as conflicts arising from the payment scheme for credit ratings, financial arrangements with rated issuers, and relationships between the credit rating agency and the underwriter for securities issued by the rated issuer.
- *Competitive Issues.* The Commission could be given authority to adopt rules prohibiting or requiring the disclosure of potentially anticompetitive practices, such as tying arrangements, solicitation of payment for unsolicited ratings, and threats to modify ratings based on payment for related services.
- *Systematic Procedures Designed to Ensure Credible and Reliable Ratings.* To ensure the integrity of the ratings process, the legislation could require a credit rating agency registered with the Commission to adopt and implement systematic procedures designed to ensure credible and reliable ratings, in accordance with Commission rules. The legislation should not, however, regulate the substantive decision-making of rating agencies or the content of the ratings they assign.
- *Market Assessments of the Quality of Credit Ratings.* The legislation could authorize the Commission to adopt rules to define and establish minimum standards for determining whether a credit rating agency is generally accepted in the financial markets as an issuer of credible and reliable securities ratings. Market acceptance historically has been a crucial element in assessing whether a credit rating agency should qualify as an NRSRO or otherwise should be relied upon for regulatory purposes.
- *Misuse of Nonpublic Information.* The legislation could require a registered credit rating agency to adopt and implement written compliance policies and procedures designed to ensure compliance with the federal securities laws, manage conflicts of interest, and prevent the misuse of nonpublic information. In this regard, the Commission could be given authority to adopt rules requiring specific policies and procedures.

In addition to the specific rulemaking authority outlined above, the Commission could be given general rulemaking authority to carry out the purposes of the legislation and to classify persons, applications, reports, and other matters and prescribe greater, lesser, or different requirements for different classes. This general authority would permit the Commission to tailor its rules as may be appropriate in light of continuing cooperation with international regulatory bodies.

IV. Books and Records, Reporting, and Examinations. To the extent the Commission is granted rulemaking authority in the areas described above, it would be essential for the Commission to be able to enforce the substantive regulations through examination and

inspection tools, presumably modeled on the Securities Exchange Act of 1934 (“Exchange Act”). In this regard, the legislation could give the Commission authority to require a registered credit rating agency to make and keep such records, and make and disseminate such reports, as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. The Commission also could be given the authority to examine all records of a registered credit rating agency.

- *Non-Waiver of Privileges.* For an examination program to be effective, it is critical that the legislation permit a registered credit rating agency, as well as other regulated entities, to produce or disclose to the Commission any document or information that is subject to any Federal or State law privilege, or to the protection provided by the work product doctrine, without waiving the privilege or protection as to any other person. This provision would address a significant policy concern of regulated entities and greatly assist the Commission’s examination program.

V. Enforcement Authority. Effective implementation of any regulatory framework would require that the Commission be granted administrative and civil enforcement authority comparable to that applicable to other entities registered under the Exchange Act. This would enable the Commission to bring an administrative action or civil injunctive action to enforce compliance by a registered credit rating agency, or any person associated with such credit rating agency, with the provisions of the Exchange Act and the rules thereunder, including those provisions specifically applicable to registered credit rating agencies.

VI. Statutory Framework. The legislation could be incorporated into the Exchange Act. If so, the general provisions in that Act, including those relating to investigations, enforcement procedures, exemptive authority, and general rulemaking authority, would apply to the regulation of registered credit rating agencies, with such conforming changes as may be appropriate.